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**CITY OF OAKLAND**

Required Communications  
and Recommendations

Fiscal Year Ended  
June 30, 2009

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**CITY OF OAKLAND**  
Required Communications and Recommendations  
Fiscal Year Ended June 30, 2009

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SACRAMENTO

WALNUT CREEK

LOS ANGELES

NEWPORT BEACH

SAN DIEGO

Honorable Mayor and Members of the City Council  
City of Oakland, California

We have audited the financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of the City of Oakland (the City) as of and for the year ended June 30, 2009, and have issued our report thereon dated November 25, 2009. Our opinions on the financial statements, insofar as they relate to the Oakland Redevelopment Agency (ORA), are based solely on the report of other auditors. This report does not include communications related to the audit of the ORA. Additionally, although we performed the audit of the Port of Oakland (the Port), the City's discretely presented component unit, this report does not include the communications related to that audit because separate communication is made to the Port's Board of Port Commissioners. In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of the City as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a material weakness.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described as comment 2009-1 to be a material weakness.

The City's written response to the finding identified in our audit is described in the Schedule of Recommendations and Responses. We did not audit the City's response and, accordingly, we express no opinion on it. In addition, we have already discussed our comment and recommendation with various City personnel, and we would be pleased to discuss it in further detail at your convenience, to perform any additional study of this matter, or to assist you in implementing the recommendation.

Additionally, we have included in this letter a report on communications with the City Council as required by auditing standards generally accepted in the United States of America.

This communication is intended solely for the information and use of management, City Council, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

MACIAS GINI & O'CONNELL LLP

*Macias Gini & O'Connell LLP*

Certified Public Accountants  
Oakland, California

November 25, 2009

## **CITY OF OAKLAND**

Required Communications and Recommendations  
Fiscal Year Ended June 30, 2009

### **REQUIRED COMMUNICATIONS**

Professional standards require that we provide you with the following information related to our audit.

#### **I. The Auditor's Responsibility Under U.S. Generally Accepted Auditing Standards and OMB Circular A-133**

As stated in our engagement letter dated February 26, 2009, our responsibility, as described by professional standards, is to express opinions about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve you or management of your responsibilities.

In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions is not an objective of our audit. Also in accordance with OMB Circular A-133, we will examine, on a test basis, evidence about the City's compliance with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* applicable to each of its major federal programs for the purpose of expressing an opinion on the City's compliance with those requirements. While our audit will provide a reasonable basis for our opinion, it will not provide a legal determination on the City's compliance with those requirements. Our reports required under OMB A-133 are in process and those reports will be provided to you when they have been issued.

#### **II. Other Information in Documents Containing Audited Financial Statements**

During the year, the City included audited financial statements for the year ended June 30, 2008 in various debt offering documents (e.g., Official Statements.) We do not have an obligation to perform any procedures to corroborate other information contained in such debt offering documents. We were not associated with and did not have any involvement with such documents. Accordingly, we did not perform any procedures on these documents and provide no assurance as to the other information contained in the debt offering documents.

Our responsibility for other information in documents containing the City's financial statements and our report thereon does not extend beyond financial information identified in our report, and we have no obligation to perform any procedures to corroborate other information contained in these documents. We have, however, read the other information included in the City's comprehensive annual financial report; and no matters came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or its manner of presentation, appearing in the financial statements.

## CITY OF OAKLAND

### Required Communications and Recommendations Fiscal Year Ended June 30, 2009

#### REQUIRED COMMUNICATIONS (Continued)

##### III. Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to you in our meeting about planning matters on July 22, 2009.

##### IV. Significant Audit Findings

###### *Qualitative Aspects of Accounting Practices*

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 2 to the basic financial statements. As described in Note 12 to the basic financial statements, the City adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, effective July 1, 2008.

In addition, the City presents the Port of Oakland (Port) in a unique manner as compared to other local governmental entities with port operations. All local government entities we sampled reflect their ports as departments of the organization rather than as a discretely presented component unit. Some of these ports have similar management structures with a Board of Commissioners appointed by the sponsoring city's mayor/city council to oversee the operations of the port. Management's representation to us was that the Port operates with a separate legal standing (i.e. using its own corporate powers) under the Charter, which would allow for this presentation. In addition, the City Attorney's Office has represented that the Port operates very similar to a corporation with the Charter acting as its Articles of Incorporation and By-Laws. Ultimately, the City's presentation of the Port makes it less comparable to other cities that have port operations, thus, being a unique presentation.

We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- *Fair value of investments.* The City's investments are generally carried at fair value, which is defined as the amount that the City could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller and is generally measured by quoted market prices.
- *Estimated unbilled sewer service revenue.* The estimates for unbilled sewer service revenue are based on an evaluation of the EBMUD reports, cash flows, monthly billing cycles and historical billings.
- *Estimated allowance for losses on accounts receivable.* The allowance for losses on accounts receivable was based on management's estimate regarding the likelihood of collectibility.

## CITY OF OAKLAND

### Required Communications and Recommendations Fiscal Year Ended June 30, 2009

#### REQUIRED COMMUNICATIONS (Continued)

- *Estimated allowance for losses on loans receivable.* The allowance for losses on loans receivable was based on the types of loan (e.g., forgivable, deferred, grant or amortizing) and management's estimate regarding the likelihood of collectibility based on loan provisions and collateral.
- *Useful life estimates for capital assets.* The estimated useful lives of capital assets were based on management's estimate of the economic life of the assets.
- *Valuation of the net pension asset.* The net pension asset is the amount that exceeded the City's actuarially determined annual required contribution, which is based upon certain approved actuarial assumptions. This amount is then amortized over the amortization period used by the actuary to recognize the excess contribution as pension costs over time.
- *Estimated claims liabilities.* Reserves for estimated claims liabilities were based on actuarial evaluations using historical loss, other data and attorney judgment about the ultimate outcome of the claims.
- *Annual required contributions to pension and other postemployment benefit plans.* The City is required to contribute to its pension plans at an actuarially determined rate and to measure other postemployment benefit costs based upon certain approved actuarial assumptions.

We evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the financial reporting units that collectively comprise the City's basic financial statements.

#### ***Difficulties Encountered in Performing the Audit***

We encountered no significant difficulties in dealing with management in performing and completing our audit.

#### ***Corrected and Uncorrected Misstatements***

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

#### ***Disagreements with Management***

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

#### ***Management Representations***

We have requested certain representations from management that are included in the management representation letter dated November 25, 2009.

## **CITY OF OAKLAND**

### **Required Communications and Recommendations Fiscal Year Ended June 30, 2009**

#### **REQUIRED COMMUNICATIONS (Continued)**

##### ***Management Consultations with Other Independent Accountants***

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

##### ***Other Audit Finding or Issues***

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.



## CITY OF OAKLAND

Required Communications and Recommendations  
Fiscal Year Ended June 30, 2009

### SCHEDULE OF RECOMMENDATIONS AND RESPONSES

#### *Comment No. 2009-1 – Material Weakness* **Internal Service Fund Deficits**

Governments often use internal service funds to centralize certain services and then allocate the costs of those services within the government. U.S. generally accepted accounting principles (GAAP) permit the use of internal service funds to report any activity that provides goods or services to the government on a cost-reimbursement basis. That is, the goal of an internal service fund should be to measure the full cost (including cost of capital assets) of providing goods or services for the purpose of fully recovering that cost through fees or charges. Accumulating significant deficits or excess net assets are indicative of the internal service activity not being operated on a cost-reimbursement basis. Under such circumstances, it may no longer be appropriate to report the activity in an internal service fund under GAAP.

The City has not set user fees to recover the full cost of services. Due to the deficiency in charges for services, the internal service funds have essentially borrowed monies from the General Fund in order to maintain operations. While the City made an improvement in the Equipment Fund, reducing its deficit by more than half, the deficit increased in the Facilities and Central Stores Funds. The overall net assets deficit of internal service funds grew by \$3.1 million and the overall borrowings from the General Fund grew by \$1.7 million.

The City has acknowledged this matter as significant and has made an effort to take corrective measures. The City prepared a “rebalancing plan” for its internal service funds, which was first adopted for the fiscal year 2005-07 policy budget, which attempted to cure the internal service fund deficit by fiscal year 2014-15. However, the rebalancing plans put in place in fiscal years 2006 and 2007 were not followed correctly due to the lack of general fund resources to make the required annual payments. As such, the City restructured its rebalancing plan as part of the recently adopted fiscal year 2009-11 budget. This newly restructured rebalancing plan has been modified to cure the net assets deficit of internal service funds by fiscal year 2018-19. In addition, the City adopted a financial policy that requires one-half of any one-time revenues received to be used specifically to reduce the net assets deficit of internal service funds.

The need for the City to restructure its initial rebalancing plan, and in light of current economic pressures affecting the City, brings into question its ability to manage its internal service funds on a cost-reimbursement basis, as its accumulated borrowings have reached \$50.8 million as of June 30, 2009. We recommend that the City monitor the progress of its restructured rebalancing plan very closely to ensure its feasibility. If it is determined that the plan is not feasible and that the City does not intend to or cannot recover the full cost of providing goods or services within a reasonable period of time, then the use of internal service funds is no longer appropriate under GAAP and should not be used for financial reporting purposes.

#### *Management Response:*

During the 2009-11 budget, the City revised the repayment plan for the internal service funds to eliminate the funds net asset deficit by 2018-19. In addition, the City adopted a financial policy during the 2009-11 budget that requires half of one-time revenues received to be used specifically to reduce the net assets deficits of internal service funds. Receipt of such one-time assets – and their subsequent deposit into the internal service funds, as required by the financial policies and barring any fiscal emergencies – will, in essence, expedite the “repayment” of the negative internal service balances.

It is management’s intent to take every step possible to ensure such an expedited repayment, in advance of FY 2018-19. Currently, the City is reviewing all of its surplus real estate assets to determine the feasibility of sale in the next one to three years.

## CITY OF OAKLAND

Required Communications and Recommendations  
Fiscal Year Ended June 30, 2009

### STATUS OF PRIOR YEARS' RECOMMENDATIONS

2007-2 Comment:

#### ***Internal Service Funds***

Condition/Effect/  
Recommendation:

The City reports five internal service funds, Equipment, Radio, Facilities, Reproduction and Central Stores. Governments often use internal service funds to centralize certain services and then allocate the costs of those services within the government. U.S. generally accepted accounting principles permit the use of internal service funds to be used to report any activity that provides goods or services to the government on a cost reimbursement basis. That is, the goal of an internal service fund should be to measure the full cost (including cost of capital assets) of providing goods or services for the purpose of fully recovering that cost through fees or charges. Therefore, if the City does not intend to recover the full cost of providing goods or services, then the use of internal service funds would not be appropriate.

As discussed the last two years, we are becoming increasingly concerned with the growth in both the deficits of certain internal service funds and the interfund loans used to support those services. The City has attempted to cure the internal service fund deficits by increasing the charges to the departments; however, those increases have not kept up with the increases in actual costs. Therefore, we recommended the City review its current budget repayment plan and revise it to cure the deficit over a reasonable period of time, such as three to five years.

The City's response was to maintain the current rebalancing plan for internal service funds in its adopted the FY 2007-09 policy budget, which cures the deficits by FY 2014-15.

Status:

The position of the City's internal service funds continued to worsen, and the rebalancing plan has been restructured. See current year finding at 2009-01.

2008-1 Comment:

#### ***Accounting for the City's Sewer Service Revenues***

Condition/Effect/  
Recommendation:

We were unable to complete our documentation of internal controls over sewer service revenues, as we were unable to meet with Community and Economic Development Agency (CEDA) staff. While we were able to document certain controls, such as the development of user rates and recording of receipts from East Bay Municipal Utility District (EBMUD), we were not able to determine whether the City has adequate controls over the monitoring of EBMUD services. Due to a lack of cooperation by CEDA, we assumed that controls and control documentation did not exist. Therefore, internal controls over the collection of sewer service revenues was considered a material weakness, as we were unable to determine the adequacy of internal controls and whether or not they were operating effectively. We were able to mitigate this audit risk by conducting substantive procedures, which included confirming cash receipts with EBMUD and application of analytical procedures.

## CITY OF OAKLAND

### Required Communications and Recommendations Fiscal Year Ended June 30, 2009

#### STATUS OF PRIOR YEARS' RECOMMENDATIONS (Continued)

During our substantive procedures, we determined that the City did not have an adequate understanding of the EBMUD collection process and the timing of remittances to the City.

We recommended that the City document its internal controls over sewer service revenues, which included (1) performing risk assessments; (2) establishing controls, such as monitoring the billing and collecting activities performed by EBMUD; (3) establishing proper communication within the City Departments; and (4) establishing accrual procedures at year-end that capture all billed receivables and a basis for estimating the unbilled receivables.

Status: Management held a meeting among CEDA, the Public Works Agency, and the Finance and Management Agency to identify the most appropriate way to monitor the sewer system revenues collected by EBMUD on behalf of the City. The inter-agency meeting resulted in a monitoring process that was implemented during fiscal year 2008-09.

This has been fully implemented.

2008-2 Comment:

#### *Accounting for the City's Net Pension Asset*

Condition/Effect/  
Recommendation:

During our review of the Oakland Police and Fire Retirement System (PFRS) financial statements for the year ended June 30, 2008, we noticed a change in reporting of actuarial information. The FY2008 PFRS report disclosed a six-year trend of actuarial required contribution (ARC) requirements in its required supplementary information, which had previously been reported as zero in past PFRS reports.

Upon further investigation, it was determined that the past PFRS reports were incorrect and that there has been past ARC requirements for the City which were not communicated or considered in its calculation of the net pension asset on the statement of net assets of its governmental activities. The net pension asset is the result of City contribution to PFRS that exceeded the actuarially determined annual required contribution, which originated from the bond proceeds of the 1997 Pension Obligation Bonds. This amount should then be amortized along with impact of subsequent annual ARC requirements to recognize the effects of excess/deficient contributions as pension costs over time.

We recommended going forward that the City's Finance and Management Agency accounting and retirement staff work with the PFRS actuary to calculate the annual pension cost and changes to net pension assets.

Status:

This has been fully implemented.